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AGENDA ITEM 8a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. **SUBJECT:** Credit Enhancement Program Annual Review
- II. **PROGRAM:** Credit Enhancement Program
- III. **RECOMMENDATION:** Information Item – Annual Review
- IV. **ANALYSIS:**

Program Summary and Statistics:

From January 1, 2007 through December 31, 2007, staff underwrote approximately \$819 million in new commitments compared to \$198 million in the previous reporting period. Total program commitment as of December 31, 2007 is approximately \$1.5 billion which generated \$2.0 million in net earnings during the reporting period versus \$1.7 million in the previous reporting period. Please refer to Table 1 for commitment descriptions and fee breakdowns.

Table 1. Commitment Amount and Fees

Security Description	Sector	Total Commitment	Expiration Date
CA Dept of Water Resources ser 2002	Electric Utility	75,000,000	11/30/2010
CA Dept of Water Resources ser 2005	Electric Utility	75,904,110	12/1/2008
City of New York ser I	Municipality	75,647,260	4/1/2013
City of New York ser H	Municipality	142,723,601	11/1/2011
Michigan State Building Authority ser 2003	State	100,000,000	11/9/2010
State of California ser 2003	State	75,000,000	12/11/2009
Texas Transportation Commission ser 2006	State	75,863,014	12/13/2013
Vermont Student Assistance Corp ser 2005	Student Loans	63,893,102	6/20/2012
LA Dept of Water Resources ser 2001	Public Power	151,676,712	1/31/2010
UC Regents Medical Center ser 2007	Higher Education	24,307,457	1/30/2010
SMUD 2007 ser 2007	Electric Utility	51,232,877	1/23/2012
San Antonio CPS Energy ser 2007	Electric Utility	75,000,000	11/1/2012
State of California ser 2007	State	256,780,822	10/30/2012
Nashville and Davidson County ser 2007	County	133,990,868	7/11/2014
Tennessee State School Bond Authority	Higher Education	126,914,063	3/30/2014
Total 2007 Outstanding Commitments		\$ 1,503,933,885	
Net Earnings		\$ 1,960,747	

Out of the \$1.5 billion in total Program commitments, approximately 41.2% were for letters of credit and 58.8% were for standby purchase agreements (liquidity lines). Geographically, California and Texas represented 67% of the total Program commitments. General obligation commitments dominated the portfolio with an exposure of 40.5% (please refer to Chart 1 and Chart 2 for additional detail on geographic and sector distributions).

Chart 1. Geographic Breakdown as of 12/31/2007

Geography	Commitment Amount	%
<i>California</i>	\$ 620,137,985	41.2%
<i>Texas</i>	390,771,689	26.0%
<i>New York</i>	175,984,169	11.7%
<i>Vermont</i>	126,914,063	8.4%
<i>Tennessee</i>	126,232,877	8.4%
<i>Michigan</i>	63,893,102	4.2%

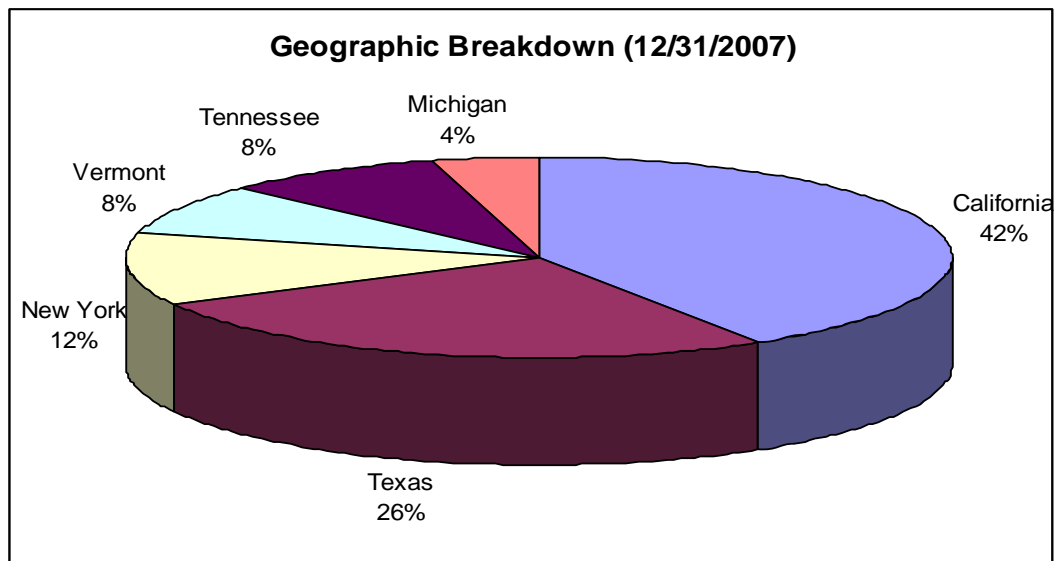
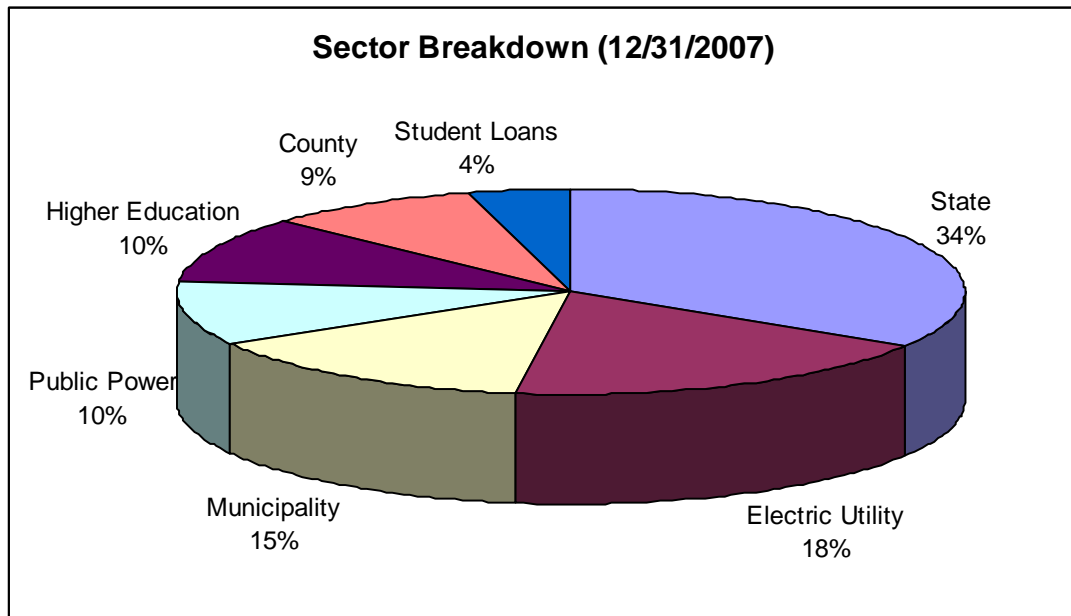


Chart 2. Sector Breakdown as of 12/31/2007

Sector	Amount	%
<i>State</i>	\$ 507,643,836	33.8%
<i>Electric Utility</i>	277,136,986	18.4%
<i>Municipality</i>	218,370,861	14.5%
<i>Public Power</i>	151,676,712	10.1%
<i>Higher Education</i>	151,221,520	10.1%
<i>County</i>	133,990,868	8.9%
<i>Student Loans</i>	63,893,102	4.2%



Discussion:

The capital markets experienced a liquidity squeeze which started in the third quarter of 2007 caused by concerns in the housing and sub-prime lending areas. The turmoil in the subprime market not only impacted the structure product market, but it also spilled over into the banking and the monoline insurance sectors as a result of direct or indirect portfolio exposure to the subprime securities. In the fourth quarter of 2007, the rating agencies downgraded a few banks and placed several monoline insurers' on ratings watch for possible downgrade. The combination of the market's increased aversion to risk and the actions taking by the ratings agencies have created an opportunity for CalPERS to leverage its AAA rating and un-utilized capacity.

Over the past two years, staff has strategically conserved capacity due to the low pricing environment for both liquidity and credit resulting from an overabundance of supply. Given the set backs stemming from the sub-prime crises, many participants have either scaled back or exited the credit enhancement market altogether. As a result, staff has seen a significant reduction in the supply of credit / liquidity facilities and pricing has improved tremendously. Staff will be ramping up commitments in order to take advantage of the recent price dislocations. In addition, staff is planning to recommend a few policy amendments in the upcoming Investment Policy Subcommittee which will streamline the policy in order to capitalize on recent market opportunities.

Wilshire Associates opinion letter is shown in attachment 1.

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS:

The Credit Enhancement Program generated net earnings of \$2.0 million for the year ending December 31, 2007.

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